



# Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

## Governing's Seven Deadly Sins

Earlier this month, *Governing Magazine* published the article, "The 7 deadly sins of public finance: sure-fire ways to get it wrong on fiscal policy." The *Oklahoma Economic Report* takes a look at our state's experience with these public finance pitfalls.

### 1. Balancing the Budget with One-Time Fixes

*"States and many cities have a legal obligation to balance their budgets each year. But there are all sorts of tricky maneuvers that can place a government in technical compliance with that rule. Shifting payments into the next fiscal year, for example, can instantly take the problem off the current books. But it serves only to make the following year's*

*budgeting that much more difficult."* – *Governing.*

Oklahoma's budget has become dependent on one-time sources of revenue and other one-time fixes in both good times and bad.

During the recession, the state deferred payment of tax incentives and supplemented the budget by tapping into revolving funds and other accounts such as the Unclaimed Property Fund. As the state's economy rebounded, the reliance on these accounts continued.

In fiscal year 2012, legislators spent almost \$400 million in non-recurring funds to increase the budget bill by five percent over the prior year. Even with

continued economic growth, nearly \$300 million in one-time money was employed in the FY 13 budget.

For the FY 14 budget, budget writers agreed to phase out dependence on one-time funds over a two-year period and reduced use of those funds in that year's budget to \$126 million. Lawmakers reverted to their dependence on one-time sources of funding, using nearly \$292 million in transfers to help enact a FY 15 general appropriations bill larger than last year's.

Additionally, the state has historically pushed some operating expenses into the start of a new fiscal year. The Department of Corrections routinely

**SEE DEADLY SINS PAGE 3**

### Inside

- **Treasurer's Commentary:**  
Cents and sensibility
- **Oklahoma GDP expands**
- **"Notable quotes"**
- **State Gross Receipts continue rise in May**
- **State unemployment rate holds steady in May**

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### The Seven Deadly Sins of Public Finance

1. Balancing the Budget with One-Time Fixes
2. Ignoring the Long-Term Consequences of a Deal
3. Taking on Too Much
4. Misapplying a Temporary Windfall
5. Shortchanging Pension Obligations
6. Making Unrealistic Projections About Rates of Return
7. Ignoring Financial Checks and Balances

Courtesy of Governing Magazine



## Treasurer's Commentary

By Ken Miller, Ph.D.

### Cents and sensibility

Two years ago, I penned a column, *Stop the Madness*, calling on the Legislature to inject common sense into the budget process by replacing short-term tactics with long-term strategies. By that measure, this year's budget is still a bit mad.

Sure, there were sound financial accomplishments like creating a defined contribution plan for new state employees, funding needed repairs to the State Capitol and better prioritization. But unsound is reverting to an overdependence on one-time funds, adopting a budget larger than last year's with \$188 million less in certified revenues, passing a tax cut without corresponding spending cuts, and not addressing the teachers retirement system, whose \$8 billion unfunded liability is the largest debt on the state's balance sheet.

While the newly-minted budget gets points for creativity, it loses them for inching the state closer to a structural imbalance. Suboptimal financial practices are understandable during times of extreme fiscal distress. Most would not fault use of reserve funds during the Great Recession. But such tactics should be rare, not business as usual – and definitely should not occur during economic expansions.

The sad truth is our state budget has become dependent on using one-time funds in both good times and bad. Oklahoma's economy has been expanding the past three years, yet legislators tapped nearly \$1 billion in non-recurring revenues over that period – some appropriately so, but most not – to spend more than the amount certified.

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The equalization board just declared the FY-15 state budget out of balance and struck nearly \$7 million in overspending due to an unconstitutional tapping of one-time funds from the state regents. Two sessions ago, about \$93 million meant for the Rainy Day Fund was intercepted by legislators and the year before that another \$21.4 million was diverted in the same manner.

Though these monies were earmarked for legitimate needs, the ends did



not justify the means. All three actions violated at least the spirit of the constitutional balanced budget provision in a seemingly desperate attempt to find more dollars to spend while simultaneously working to further reduce available revenues.

Outside of government, it's well-accepted that non-recurring revenues should not be used for ongoing expenditures and that recurring revenue streams should not be cut when current costs exceed them. Until the Legislature proves it can live within its means, it really should stop reducing them.

Each year, the temptation is for budget writers to posture until the last minute and then quickly adopt an agreement to avoid overtime. But state budgets have much broader implications than simply funding agencies; they communicate much about our fiscal health, priorities and future.

**SEE COMMENTARY PAGE 3**



## Commentary

### FROM PAGE 2

Moody's Investor Services recently downgraded Kansas due to overdependence on one-time funds, lowering the income tax without

offsetting cuts in spending, and maintaining large unfunded pension obligations.

Oklahoma has engaged in each of these indulgences, but well-intentioned policymakers can

make adjustments before similar consequences.

Hopefully, the recent action taken by the equalization board and the Kansas downgrade will bring more sense to Oklahoma fiscal policymaking.

## Deadly sins

### FROM PAGE 1

is appropriated less than a full year's budget and later allotted a supplemental appropriation.

### 2. Ignoring the Long-Term Consequences of a Deal

*"Few governments have a long-term financial plan and even fewer have multiyear budgets. Many don't even require a fiscal analysis of proposed legislation. That's made it possible for some, facing immediate demands for wage increases, to buy off public employee constituencies by increasing retirement benefits at an unsustainable long-term cost." – Governing.*

It would be challenging for Oklahoma to develop multiyear budgets due to the difficulty of forecasting volatile revenue streams like gross production and corporate income taxes. Even so, it is possible for policymakers to consider the long-term financial implications of current year decisions. Oklahoma's Legislature does require fiscal analysis of legislation, although it does not consider the cost of inaction. Deferring maintenance or providing piecemeal funding for large-ticket items has often led to a greater expense to the state.

For example, maintenance of Oklahoma's roads and bridges were neglected for decades until a funding agreement was reached in 2005 that dedicated close to \$2 billion over a decade's time to accelerate repairs, replacement and maintenance. Similarly, decades of deferred upkeep of the State Capitol resulted in the need for a \$120 million bond to restore the crumbling building. And the American Indian Cultural Center and Museum remains unfinished while the state continues to pay \$6 million per year in interest and site maintenance expenses. However, state lawmakers ceased the damaging practice of granting cost-of-living adjustments to pensioners without providing funding.

### 3. Taking on Too Much

*"One of the reasons privatizing assets has become alluring to government is because many of them have been burned by taking on more public investments than they could handle. This frequently involves development projects funded by municipal bonds. If a project's tax revenues don't deliver, governments have to pay the difference to bondholders out of their general fund budgets – a promise that becomes an embarrassing burden for some that can ill afford the risk." – Governing.*

Oklahoma, at the state government level, rarely makes public investments in which repayment is contingent upon a level of revenue being generated. The last general obligation bond approved by voters was in 1992, and is being repaid with a portion of the tobacco tax.

Many of the state's bonds finance the construction of a building or facility; obligations which are repaid by the entity through a lease arrangement. One recent example of a lease-revenue bond is the Supreme Court Building, which pays its annual debt service with the agency's state appropriations.

This differs from revenue-based bonds which rely on a dedicated revenue stream. One of the most recognizable examples of this type of bond is Oklahoma City's series of Metropolitan Area Projects (MAPS), for which city voters approved a temporary one-cent sales tax for dedicated capital improvement projects.

Oklahoma is a low-debt state, with net tax-supported debt service at half the national average. Further, a 2013 law limits the state's annual debt service to five percent of a rolling five-year average of General Revenue Fund collections.

**SEE DEADLY SINS PAGE 4**



## Deadly sins

FROM PAGE 3

### 4. Misapplying a Temporary Windfall

*“This is the sin that many governments commit when it seems like the good times will never end. Every economic boom is followed by a bust, but elected officials are often tempted to spend money as if that weren’t true, using one-time surpluses in especially good years to cover recurring expenses that they will have to meet in the bad years. When the downturn comes, the money to meet these expenses isn’t there.” – Governing.*

One of Oklahoma’s most volatile sources of revenue is from oil and gas production, yet for decades, the state relied heavily on the gross production tax. The energy bust of 1982 decimated government funding and resulted in the state rebalancing its revenue to reduce dependence on this tax. This event also led to the creation of the state’s rainy day fund, which captures better-than-expected revenues. However, in 2005, the state had approximately \$100 million in excess revenues after the rainy day fund had reached its cap and the spending limit had been reached. Instead of applying this windfall toward debt reduction, including pension liabilities, the state mailed out \$45 per taxpayer rebate checks which did little to aid economic growth since consumers typically base behavior on permanent tax changes.

### 5. Shortchanging Pension Obligations

*“The most serious threat to some government pension plans has been a chronic unwillingness by lawmakers to contribute what is necessary to keep the plans fully funded. To be sure, many*

*governments skipped or pared down payments into pension plans during the recession. But some places did that for years prior to the downturn and continue to do it today. The longer that delay, the larger the long-term liability becomes.” – Governing.*

The total funded ratio of Oklahoma’s public pension systems is 66.5% with an unfunded liability of \$11.36 billion. The largest liability - more than \$8 billion – is attributable to the teachers’ system. Oklahoma arrived at this position primarily through two actions: granting cost-of-living adjustments without funding and a habitual failure to meet the actuarially required contribution (ARC).

FY 2013 was the first year that Oklahoma’s ARC was met on a collective basis. Typically, the state has met only about 70 percent of the ARC. This, combined with unfunded benefit adjustments, helped create the billions in unfunded liabilities currently on the state’s books.

### 6. Making Unrealistic Projections About Rate of Return

*“Every budget or financial planning document has to start with some assumptions about the rate of interest that will be earned on an invested portfolio. It’s tempting – too tempting sometimes – to stretch those assumptions beyond what sensible economics can justify. Some pension funds still base their total liabilities owed on an expected annual investment return of more than 8 percent, a figure that affects the formula used in figuring out how much governments should contribute each year.” – Governing.*

None of Oklahoma’s seven pension plans use a rate of return above 8 percent, with five of the plans using a

rate of 7.5 percent and one using a rate of 7 percent. These assumptions have not been out of balance with historical returns, but some question how realistic these rates will be going forward.

### 7. Ignoring Financial Checks and Balances

*“Don’t lose track of the money you have. It seems like the most obvious advice in the world. But in government finance and fund accounting, where there are many different ways to count the same revenue, weak financial controls can lead to serious dollar losses. Government can lose track of how much money they actually owe one of their special funds. Or lax internal monitoring can result in poor financial choices not getting flagged until it’s far too late.” – Governing*

Oklahoma has good fiscal controls, sound fiscal policies and open records on state finances. However, Oklahoma has struggled to accurately account for other state assets. Before 2005, the state did not have an inventory of all state vehicles, nor policies regulating the acquisition, operation, maintenance and disposal of them. In 2006, an effort began to identify all state-owned real property and in 2013 the Legislature adopted standards to shed underutilized properties and direct the proceeds toward asset maintenance.

There have been some lapses in governmental checks and balances that resulted in poor financial choices not being caught until after the fact. Twice within the past three years, funds that were meant for the state’s rainy day fund were diverted and used for supplemental funding. Most recently, a provision in the state budget that sought to improperly certify more funds for the budget was found to be unconstitutional.



## Oklahoma GDP expands

Real Gross Domestic Product (GDP) in Oklahoma increased by 4.2 percent during 2013, the fourth largest increase among the states, according to data released in June by the U.S. Bureau of Economic Analysis (BEA).

Oklahoma's economic growth was surpassed only by North Dakota at 9.7 percent, Wyoming at 7.6 percent, and West Virginia at 5.1 percent.

Colorado, with GDP growth of 3.8 percent, was the closest to Oklahoma's growth rate among bordering states.

Texas was reported with 3.7 percent growth, followed by Arkansas with 2.4 percent, Kansas with 1.9 percent, New Mexico with 1.5 percent, and Missouri with 0.8 percent.

The mining industry, which includes oil and gas production, was not a significant

contributor to national GDP growth.

However, it was a large factor in five of the fastest growing states: North Dakota, Wyoming, West Virginia, Oklahoma and Colorado.

Oil and gas production accounted for almost 60 percent of Oklahoma's GDP growth during 2013.

On the other hand, Alaska was the only state where GDP dropped during the year, due primarily to lower oil and gas output on the state's North Slope.

U.S. GDP was reported at 1.8 percent during the year, down from 2.5 percent in 2012.

The BEA defines real GDP as an inflation-adjusted measure that reflects the value of all goods and services produced in a given year, expressed in base-year prices.

### "Notable quotes"

"This burgeoning crusade to repeal Common Core reveals a deep and long-standing flaw in the conservative movement. We're excellent at critiquing statist proposals, but we have problems crafting workable solutions to policy problems."

– **Andrew C. Spiropoulos** in the *Journal Record*, "So much for local control"

"Sometimes ideological experiments bring unintended outcomes. I think Kansas is seeing that, and it serves as a reminder for the rest of us."

– **Treasurer Ken Miller** in the *Wall Street Journal*, "Sam Brownback's Tax-Cut Push Puts Kansas Out on Its Own"

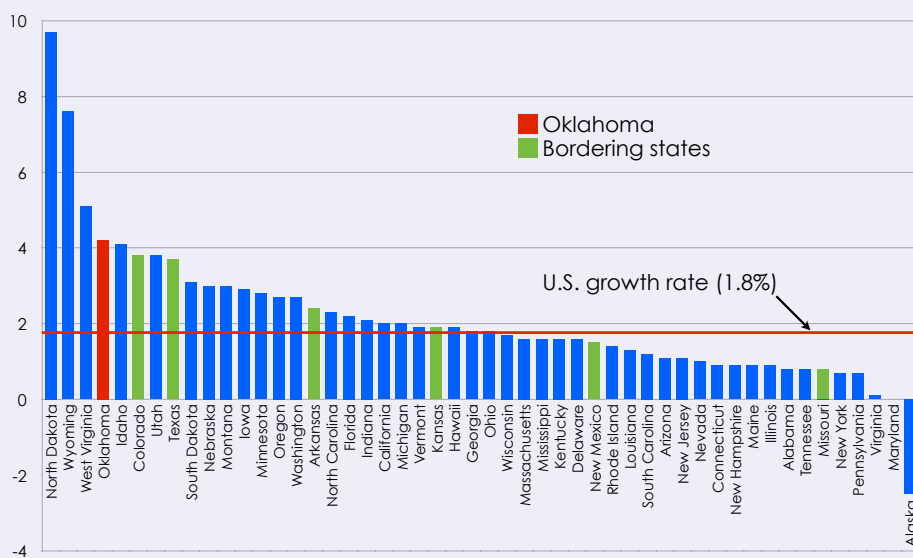
"This facility is designed for our soldiers to train and prepare to protect our nation. Instead, the federal government is using it as a cross between a boarding school and detention center for illegal immigrants."

– **Governor Mary Fallin** in a press release responding to a federal decision to use a Fort Still facility to house illegal immigrants

"Article X, Section 23 does not give the Legislature the authority to determine how much should be certified as available for it to appropriate. Only the State Board of Equalization has that authority, and the Constitution vests that authority solely with the State Board of Equalization precisely to prevent the Legislature from attempting to determine how much should be available to it for appropriation."

– **Attorney General Scott Pruitt**, *Attorney General Opinion 2014-7*

**Real GDP by State 2013**  
Percentage change from prior year



Source: Bureau of Economic Analysis



## Gross receipts & General Revenue compared

The Treasurer's June 3 Gross Receipts to the Treasury report and the Office of Management and Enterprise Services' June 10 General Revenue Fund (GRF) report contain several differences.

May gross receipts totaled \$900.7 billion, while the GRF received \$449.5 million or 49.9% of the total.

The GRF received between 33.1% and 57.1% of monthly gross receipts during the past 12 months.

From May gross receipts, the GRF received:

- Personal income tax: 53.9%
- Corporate income tax: None
- Sales tax: 45.6%
- Gross production-Gas: 59.1%
- Gross production-Oil: 72.6%
- Motor vehicle tax: 29.3%
- Other sources: 57.4%

May GRF allocations are short of the estimate by \$25.3 million or 5.3%. Fiscal year-to-date allocations are below the estimate by \$251.8 million or 4.8%.

For May, insurance premium taxes totaled \$3.38 million.

Tribal gaming fees generated \$9.98 million during the month.

## State Gross Receipts continue rise in May

Oklahoma's Gross Receipts to the Treasury report indicates the state economy continues on the upside of the business cycle, State Treasurer Ken Miller said at a State Capitol news conference.

Using collections from the state's major revenue sources as a gauge of economic performance, Miller said steady growth, especially in the oil field, is the order of the day.

"Gross collections for the month of May are almost two percent ahead of the same month of last year, and receipts for the past 12 months are higher than those

of the prior 12 months by more than three percent," he said.

"While we aren't seeing the robust growth of the early recovery, we do see a picture of measured expansion

ongoing for more than four years now."

Since hitting a gross receipts trough in February 2010, the cumulative 12-month total is

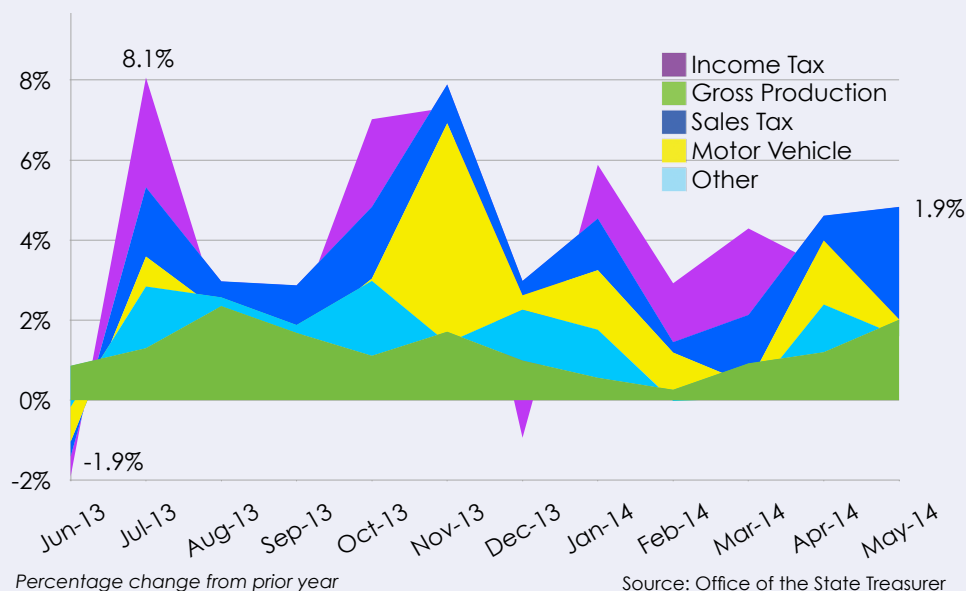
now almost 25 percent larger at \$11.63 billion, Miller said.

Miller said May collections, while positive overall, show a decrease in

**SEE REVENUE PAGE 7**

**“We see a picture of measured expansion ongoing for more than four years now.”**

**Monthly Gross Receipts vs. Prior Year**  
June 2013 – May 2014





## State unemployment rate holds steady in May

Oklahoma's seasonally-adjusted unemployment rate was listed at 4.6 percent in May by the Oklahoma Employment Security Commission, unchanged from April.

Compared to May 2013, statewide employment increased by 6,330 jobs, while the number of those listed as jobless dropped by 14,520 people according to the preliminary, seasonally-adjusted figures. The labor force shrank by 8,190 over the 12-month period.

The national unemployment rate was set at 6.3 percent in May, also unchanged from the rate reported in April.

State Unemployment Report				
OKLAHOMA	Unemp. rate*	Labor force*	Employment*	Unemployment*
<b>May '14</b>	<b>4.6%</b>	<b>1,807,120</b>	<b>1,724,250</b>	<b>82,870</b>
Apr '14	4.6%	1,816,770	1,732,410	84,370
Mar '14	4.9%	1,823,900	1,734,290	89,610
Feb '14	5.0%	1,825,140	1,734,200	90,940
Jan '14	5.2%	1,824,560	1,730,470	94,090
Dec '13	5.4%	1,823,410	1,724,920	98,480
May '13	5.4%	1,815,310	1,717,920	97,390

\* Data adjusted for seasonal factors

Source: OESC

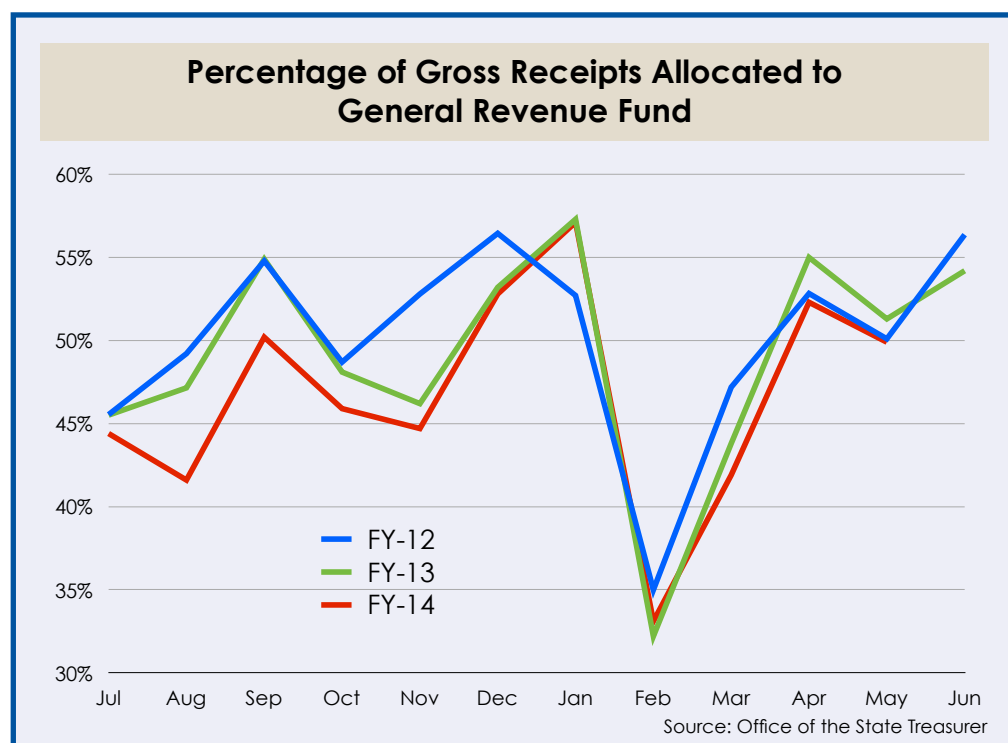
## Revenue

### FROM PAGE 6

personal income tax collections during the month, down by almost 10 percent

from the prior year. The one-month dip does not appear to be of concern. Tax commission numbers show the main component of that source – state taxes

withheld from workers' paychecks – is in line with previous months. The difference is found in estimated and final income tax payments, which can vary from month to month.



Usually volatile corporate income tax collections are in positive territory in May for the fifth time in the past 12 months, up by more than half a million dollars or 6.6 percent from May 2013 collections.

### About Gross Receipts to the Treasury

The Gross Receipts to the Treasury report provides a timely and broad view of the state's macro economy.

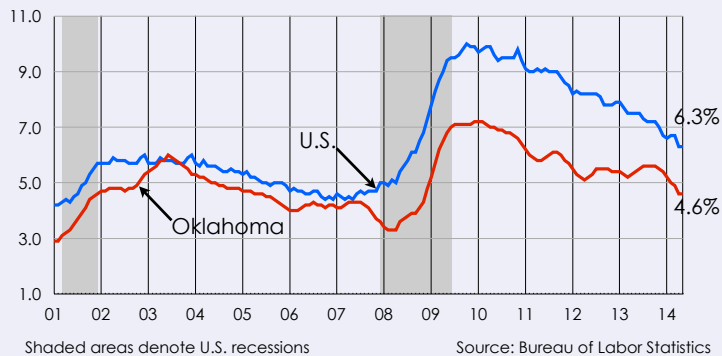
As first announced by Governor Mary Fallin, it is released in conjunction with the General Revenue Fund allocation report from the Office of Management and Enterprise Services, which provides important information to state agencies for budgetary planning purposes.



## Economic Indicators

### Unemployment Rate

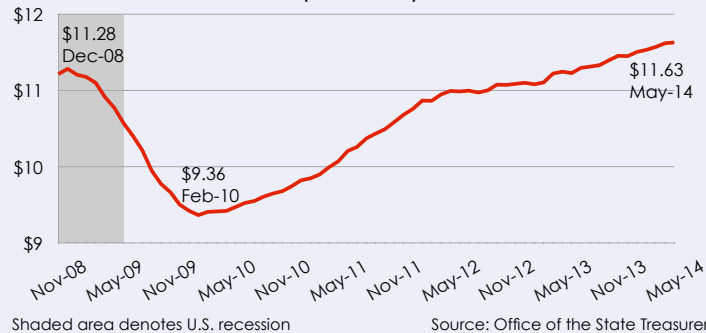
January 2001 – May 2014



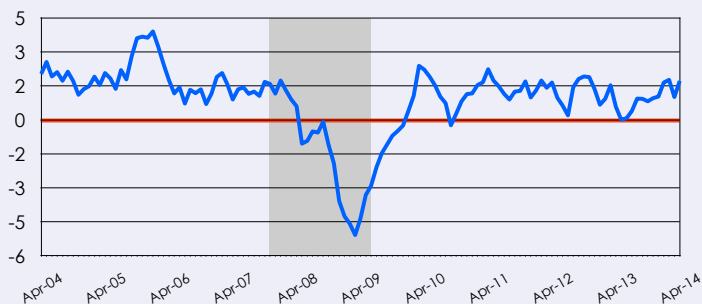
### Oklahoma 12-Month Gross Receipts

October 2008 - May 2014

(in billions)



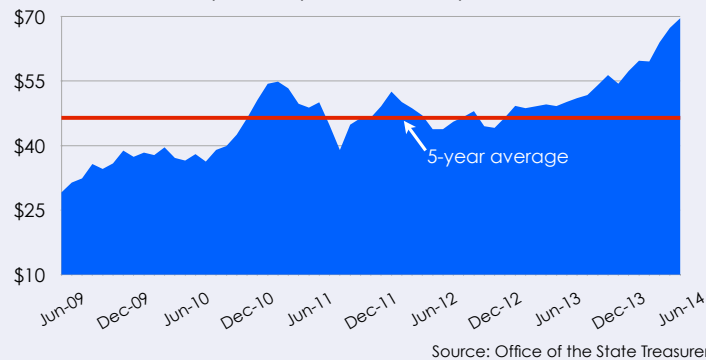
### Leading Index for Oklahoma



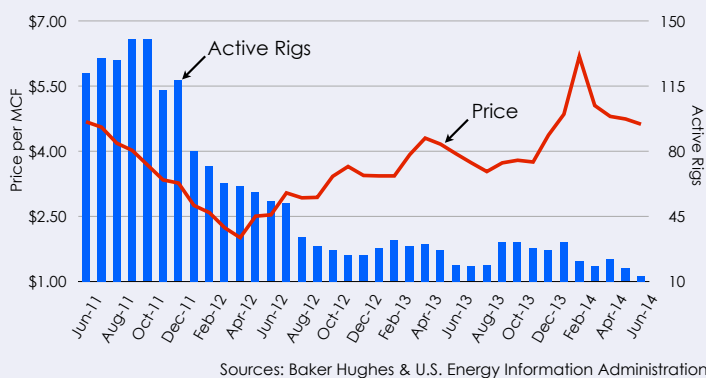
This graph predicts six-month growth by tracking leading indicators of the state economy including initial unemployment claims, interest rate spreads, manufacturing and earnings.

### Oklahoma Stock Index

Top 25 capitalized companies



### Oklahoma Natural Gas Prices & Active Rigs



### Oklahoma Oil Prices & Active Rigs

